

Message Text

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ACTION ARA-14

INFO OCT-01 IO-13 ISO-00 SP-02 USIA-06 AID-05 EB-08
NSC-05 TRSE-00 SS-15 STR-06 OMB-01 CEA-01 CIAE-00
COME-00 FRB-03 INR-07 NSAE-00 XMB-02 OPIC-03
LAB-04 SIL-01 PA-01 PRS-01 L-03 IGA-02 H-01 /105 W
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P R 272125Z JAN 78

FM AMEMBASSY BRASILIA

TO SECSTATE WASHDC PRIORITY 5832

INFO USMISSION GENEVA

C O N F I D E N T I A L SECTION 1 OF 2 BRASILIA 0716

PASS TREASURY FOR USMTN

EO 11652 GDS

TAGS ETRD EFIN BR

SUBJECT: INITIAL GOB RESPONSE ON TAX AND COUNTERVAILING DUTY MATTERS

REFS: A) SECSTATE 14792 B) BRASILIA 0594

1. SUMMARY - GOB IS VERY CONCERNED WITH IMPLICATIONS OF PROPOSED IMPLEMENTATION OF IRS REVOCATION OF TAX CREDITS ON INTEREST REMITTANCES TO US BANKS AND HAS MADE COUNTER PROPOSAL. CONCERN ALSO EXISTS THAT US IS TAKING VERY HARD POSITION REGARDING POSSIBLE BILATERAL TAX TREATY AND MINISTRY OF FINANCE DEFINITELY WANTS TO DISCUSS MATTER WITH TREASURY OFFICIALS. MINFIN GENERAL COUNSEL ALSO HAS INQUIRED ABOUT CHANCES THAT PROPOSED ELIMINATION OF TAX DEFERRAL WILL BE APPROVED BY CONGRESS AND ABOUT DEGREE OF US INTEREST IN MULTILATERAL NEGOTIATION OF A CODE ON EXPORT SUBSIDIES. FINALLY, HE EXPRESSED DIFFICULTY WITH PROPOSED RECALCULATION OF COUNTERVAILING DUTY ON SHOES. END SUMMARY.

2. MINISTRY OF FINANCE GENERAL COUNSEL FRANCISCO DORNELLES HAS CONVEYED TO FINATT QUOTE SHOCK AND DISMAY END QUOTE WITH TREASURY COMMUNICATIONS REGARDING TAX CREDITS ON INTEREST REMIT-
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TANCES AND THE PROSPECTS FOR NEGOTIATION OF A BILATERAL TAX TREATY (REF A). HE CLAIMED THAT THE PROPOSED REVOCATION OF TAX CREDITS AFTER ONE YEAR ON EXISTING LOANS WAS NOT DISCUSSED DURING HIS TALKS AT RREASURY IN SEPTEMBER 1977. HE POINTED OUT THAT THE IRS PROPOSAL WOULD INVOLVE RETROACTIVE CHANGING OF THE RULES SINCE THE BULK OF BRAZIL'S BORROWING HAS BEEN AT 5 YEARS MATURITY OR LONGER. HE SAID THAT THIS WOULD BE INCONSISTENT WITH THE GENERAL

THRUST OF THE SIMON-SIMONSEN AGREEMENT TO SEEK TO AVOID DISRUPTION OF US CAPITAL FLOW TO BRAZIL. HE SAID THAT MANY US BANKS HAVE STATED THEIR CONCERN TO THE GOB AND HE CLAIMED THAT REVOCATION OF THE TAX CREDITS ON EXISTING LOANS, EVEN AFTER A ONE YEAR GRACE PERIOD, COULD CAUSE QUOTE PANIC AND CHAOS IN THE BANKS END QUOTE.

3. DORNELLES ACKNOWLEDGED THE LEGAL RIGHT OF IRS TO REVOKE THE TAX CREDITS BUT HE APPEALED FOR GREATER FLEXIBILITY IN IMPLEMENTATION OF THE DECISION. HE PROPOSED THAT THE REVOCATION APPLY TO NEW LOANS AS OF THE DATE THE DECISION IS ANNOUNCED BUT THAT IT NOT APPLY TO EXISTING LOANS FOR UP TO A MAXIMUM OF 5 YEARS. THUS THE TAX CREDIT WOULD CONTINUE FOR ONLY A FEW MONTHS ON LOANS CONTRACTED IN THE SECOND QUARTER OF 1973 BUT FOR NEARLY 5 YEARS FOR LOANS SIGNED IN THE FIRST QUARTER OF 1978 (E.E., JUST PRIOR TO THE ANNOUNCEMENT). DORNELLES SAID THAT MINISTER SIMONSEN IS PREPARED TO SEND A LETTER TO SECRETARY BLUMENTHAL EXPLICITELY REQUESTING SUCH AN ARRANGEMENT AND SETTING FORTH THE GOB'S RATIONALE IF (REPEAT IF) PROSPECTS FOR A POSITIVE RESPONSE ARE GOOD.

4. GENERAL COUNSEL DORNELLES SAID THAT THE COMMUNICATION ON A POSSIBLE TAX TREATY SETS FORTH THE ISSUES IN A QUOTE VERY ELEMENTARY FASHION END QUOTE. HE CLAIMED THAT THE US POSITION CONTAINED THEREIN IGNORED WHAT HE INTERPRETED AS PROGRESS DURING THE TALKS IN 1976 AND THAT IT QUOTE RETURNS THE MATTER TO SQUARE ONE END QUOTE. HE DID NOT CHOOSE TO DISCUSS SPECIFIC ISSUES WITH FINATT BUT STATED THAT IN HIS VIEW IT APPEARS THAT THE US IS NOT PRE-
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PARED TO MAKE ANY CONCESSIONS BUT RATHER EXPECTS BRAZIL QUOTE TO MAKE ALL THE ADJUSTMENTS AND TO CHANGE ITS LAWS END QUOTE. HE STATED THAT NEGOTIATIONS REQUIRE CONCESSIONS FROM BOTH SIDES AND THAT AS EVIDENCE OF THE BGOB'S GOOD INTENTIONS AND FLEXIBILITY BRAZIL NOW HAS TAX TREATIES WITH 11 COUNTRIES, INCLUDING FRANCE AND GERMANY. HE ADDED THAT NEGOTIATIONS WERE COMPLETED RECENTLY WITH ITALY AND CANADA AND THAT TREATIES SHOULD BE SIGNED WITH THOSE COUNTRIES SOON. HE EXPRESSED DISAPPOINTMENT WITH THE APPARENT LACK OF AGREEMENT BETWEEN THE US AND BRAZIL ON TAX MATTERS. HE SAID

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HE BELIEVES IT IS IMPORTANT THAT THE FINANCE MINISTRY-TREASURY
TALKS IN LATE FEB-EARLY MARCH INCLUDE OVERALL TAX AFFAIRS IF ONLY
TO CLARIFY THE RESPECTIVE US AND BRAZILIAN POSITIONS.

5. ON THE OTHER MATTERS, DORNELLES ASKED FOR THE INFORMAL, UN-OFFICIAL OPINION OF TREASURY ON THE PROSPECTS FOR CONGRESSIONAL APPROVAL OF PROPOSED ELIMINATION OF TAX DEFERRAL ON US CORPORATIONS RETAINED EARNINGS ABROAD. HE COMMENTED THAT MANY US COMPANIES AND BANKS HAVE TOLD THE GOB THAT THEY FORESEE VERY LITTLE POSSIBILITY THAT TAX DEFERRAL PORTION OF THE ADMINISTRATION'S TAX PROPOSALS WILL BE APPROVED. DORNELLES ALSO ASKED IF THERE IS ANY SUBSTANCE TO RUMORS HE HAS HEARD THAT THE US NO LONGER IS INTERESTED IN ATTEMPTING TO NEGOTIATE A MULTILATERAL CODE ON EXPORT SUBSIDIES. FINALLY, DORNELLES EXPRESSED CONCERN WITH THE IDEA OF RECALCULATING THE COUNTERVAILING DUTY ON IMPORTS OF SHOES FROM BRAZIL. HE PROTESTED THAT THE GATHERING OF COST DATA WOULD BE VERY DIFFICULT IN BRAZIL BECAUSE OF THE EXISTENCE OF SO MANY COMPANIES. HE SUGGESTED THAT DATA ON DECLINING SHOE EXPORTS TO THE US IN 1977 SHOULD SUFFICE BUT AGREED THIS IS A SUBJECT FOR DISCUSSION IN LATE FEBRUARY.

5. COMMENT AND ACTION REQUESTED. WE CAN CONFIRM THAT CONCERNS EXIST AMONG MANY US BANKS REGARDING THE IRS RULING (SEE REF B).
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SECURITY PACIFIC TAX COUNSEL JOSEPH A. IRWIN (FORMERLY WITH IRS) VISITED BRAZIL RECENTLY AND TOLD FINATT THAT REVOCATION OF TAX CREDITS ON EXISTING LOANS WILL FORCE HIS BANK TO INCREASE INTEREST RATES SHARPLY AND PERHAPS EVEN CEASE LENDING TO BRAZIL. HOWEVER, DORNELLES HAS OVERSTATED THE SITUATION IN USING TERMS SUCH AS QUOTE PANIC AND CHAOS END QUOTE. FOR INSTANCE, MR. IRWIN HIMSELF POINTED OUT THAT THE LARGEST NEW YORK BANKS ARE NOT CONCERNED BECAUSE THEIR FOREIGN EARNINGS ARE SO LARGE AS A PROPORTION OF TOTAL EARNINGS THAT THEY ARE NOT ABLE TO UTILIZE FURTHER TAX CREDITS IN THE US AND THUS WILL NOT BE AFFECTED BY THE RULING ON LOANS TO BRAZIL. IN ANY CASE, THE GOB'S CONCERN IS GENUINE AND DORNELLES CLEARLY FEELS THAT ADOPTION OF THE ONE YEAR IMPLEMENTATION PERIOD

WOULD BE DISRUPTIVE AND INCONSISTENT WITH US-BRAZIL EFFORTS AT COOPERATION IN THIS FIELD. DORNELLES WOULD LIKE TO RESOLVE IRS ISSUE BEFORE FEB-MARCH MEETING IF POSSIBLE BUT IS PREPARED TO TAKE MATTER UP AT THAT TIME IF NECESSARY. ALTHOUGH DISCOURAGED BY TREASURY COMMUNICATION, HE ALSO DEFINITELY WANTS TO HAVE DISCUSSION OF GENERAL TAX MATTERS AND TAX TREATY IN FEB-MAR. TREASURY MAY WISH TO TAKE DORNELLES' COMMENTS AND PROPOSALS INTO ACCOUNT IN PREPARING PROPOSED AGENDA OR TO COMMUNICATE SEPARATE RESPONSE. GIVEN INITIATIVE OF GOB TO EXPRESS CONSIDERABLE CONCERN WITH US POSITION REGARDING SUBJECTS FOR DISCUSSION AT UPCOMING MEETING, EMBASSY WOULD APPRECIATE GUIDANCE ON TAX MATTERS AND QUESTIONS RAISED ON TAX DEFERRAL AND EXPORT SUBSIDY CODE AS SOON AS POSSIBLE.

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